No. 15985

In the United States Court of Appeals for the Ninth Circuit

ROBLEY H. EVANS and JULIA M. EVANS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 24-33) are not officially reported.

JURISDICTION

The petition for review (R. 93-96) involves deficiencies in income tax for the years 1950 and 1951 in the respective amounts of $13,191.52 and $13,048.12. Taxpayers' income tax returns for 1950 and 1951 were filed with the Collector of Internal Revenue for the District of Washington. (R. 21, 26.) On March 9, 1955, the Commissioner mailed a notice of deficiency to the taxpayers advising them of deficiencies in income tax totalling $82,361.66.

(R. 9-17, 21.) Within 90 days thereafter, on May 31, 1955, taxpayers filed a petition for redetermination of the deficiency under Section 272 of the Internal Revenue Code of 1939. (R. 3-9, 17.) On February 7, 1958, the Tax Court entered its decision, finding deficiencies in income tax for the years 1950 and 1951 in the respective amounts of $13,191.52 and $13,048.12.[1] (R. 34.) The case is brought to this Court by a petition for review filed by the taxpayers on March 10, 1958. (R. 93-96.) Jurisdiction of this Court is invoked under the provisions of Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether, under Section 23(l) of the Internal Revenue Code of 1939 as applied to the particular facts of this case, the Tax Court was correct in holding that "a reasonable allowance" for depreciation on automobiles used in the taxpayer's business is provided by computing the depreciation in accord with taxpayer's well-established business experience and practice, *i.e.*, depreciation of the automobiles over their useful life in the taxpayer's business, taking into consideration in such computation as salvage value the considerable resale value which taxpayer recovers at the termination of the properties' useful life in his business.

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[1] In the Tax Court, the taxpayers conceded that certain of the adjustments made by the Commissioner were correct, and the Commissioner also conceded that certain of his adjustments were improper. The only issue left for decision arose from the Commissioner's partial disallowance of claimed depreciation deductions.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and Regulations are set forth in Appendix A, *infra.*

STATEMENT

A portion of the facts was stipulated. (R. 20-24.) The findings of the Tax Court (R. 26-30), which must be accepted as the facts of the case unless shown to be clearly erroneous, may be summarized as follows:

The taxpayers, Robley H. Evans and Julia M. Evans, are husband and wife, residing in Bellevue, Washington. (R. 26.)

During the years 1950 and 1951, Robley H. Evans (hereinafter called the taxpayer)[2] was engaged in the business of leasing automobiles in the vicinity of Seattle. He has been in that business as a proprietor since 1936. During 1950 and 1951, taxpayer leased all of his automobiles to Evans U-Drive, Inc. (hereinafter referred to as U-Drive), a corporation, at the rate of $45 per month per automobile. Taxpayer was the manager of U-Drive. (R. 26.)

The lease agreement between taxpayer and U-Drive provided that taxpayer would furnish and lease to U-Drive a sufficient number of automobiles to efficiently operate and conduct an automobile rental business. Taxpayer retained title to the automobiles, and had the right to sell and dispose of any of the automobiles at any time. U-Drive agreed to pay all expenses of maintenance and repair of the automo-

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[2] Julia M. Evans is a party solely because of the filing of joint returns for the two taxable years involved, *i.e.*, 1950 and 1951.

biles, and also to keep the automobiles insured against liability for personal injury or property damage. U-Drive also assumed the risk of loss or damage. A supplemental agreement dated December 1, 1951, gave U-Drive an option to purchase any automobile in its possession at any time, for the actual cost of the automobile to taxpayer. (R. 26-27.)

U-Drive engaged in two types of activity during the taxable years. It leased about 30 to 40 per cent of its automobiles to customers for long periods of time, *i.e.*, 18 to 36 months, and it rented the remainder of its automobiles to the general public on a short-term basis, *i.e.*, for a few hours, a few days, or a few weeks. (R. 27.)

Taxpayer normally kept a supply of Chevrolet, Ford and Plymouth automobiles on hand, which he purchased new from local automobile dealers, usually at the factory price. He endeavored to maintain a modern fleet of rental automobiles as this was necessary to meet the demands of U-Drive's leasing and rental business. (R. 27.)

Taxpayer periodically owned more automobiles than were necessary for the efficient operation of U-Drive's short-term rental business. When this situation occurred, he would examine the cars in use and would sell those that were not needed. The oldest and least desirable automobiles were sold first. When sold, the automobiles usually had been driven an average of 15,000 to 20,000 miles and were generally in good mechanical condition. Many automobiles were sold at the end of the tourist season, *i.e.*, after Labor Day. (R. 27-28.)

At the termination of U-Drive's extended period leases, the automobiles would be returned to taxpayer who would sell them. When sold, the automobiles might have been driven up to 50,000 miles. They were usually in good mechanical condition and state of repair at the time of sale. (R. 28.)

The surplus automobiles sold by taxpayer could have been used longer than they were; however, customers demanded late model automobiles that were currently in style. Older automobiles did not have much value as rental vehicles. During the taxable years, taxpayer sold the automobiles used by U-Drive in the short-term rental phase of its business after they had been used about 15 months. And he usually sold the automobiles which had been leased for extended periods as soon as the lease was terminated. If a new lease was executed, a new car was usually provided for the lessee. (R. 28.)

Taxpayer sold most of his surplus automobiles to used car dealers, jobbers, or brokers. As a general rule, the automobiles were sold at current wholesale prices. Taxpayer did not advertise the sales of his automobiles nor did he maintain a showroom or any other retail facilities for sale of his surplus automobiles. (R. 28.)

Taxpayer's tax returns for 1950 and 1951 disclosed that he sold 140 and 147 automobiles, respectively, in those years. (R. 28.) The average cost, sales price, depreciation claimed, and gain per automobile, were approximately as follows (R. 29):

Year	Cost	Sales Price	Depreciation Claimed	Gain
1950	$1,650	$1,380	$515	$245
1951	1,495	1,395	450	350

Most of the automobiles sold had been held by taxpayer less than 15 months. (R. 29.)

On his tax returns for the years 1950 and 1951, taxpayer claimed depreciation on the automobiles he leased to U-Drive in the respective amounts of \$77,972.71 and \$92,890.05. These amounts were computed and the deductions claimed on the basis that the automobiles had an estimated useful life of 4 years, with no salvage value at the end of the 4-year period. (R. 29.)

The Commissioner determined allowable depreciation on these automobiles for the years 1950 and 1951 on the basis of an estimated useful life for each automobile of 17 months and a salvage value of \$1,325 at the end of the 17-month period, or the amount of undepreciated cost at January 1, 1950, for automobiles in use at that date, if less than \$1,325. (R. 29.)

The Tax Court found that the automobiles leased to U-Drive during the taxable years for use under extended-term leases had a useful life of 3 years and a salvage value of \$600. However, if the undepreciated cost of such automobiles in service at January 1, 1950, was less than \$600, then that amount would be the salvage value of those automobiles. (R. 29.)

The Tax Court further found that the automobiles leased to U-Drive during the taxable years for short-term rental use had a useful life of 15 months and a salvage value of \$1,375. However, if the undepreciated cost of such automobiles in service at January 1, 1950, was less than \$1,375, then that amount would be the salvage value of those automobiles. (R. 30.)

SUMMARY OF ARGUMENT

Section 23(l) of the Internal Revenue Code of 1939 permits the deduction from gross income of "A reasonable allowance for the exhaustion wear and tear (including a reasonable allowance for obsolescence) * * * of property used in the trade or business, * * *." The basic and sole standard which Congress has laid down in Section 23(l) is the requirement that the annual depreciation deduction *reasonably* reflect that portion of the value of capital assets consumed in earning the gross income for the taxable year. Section 23(l) does not provide for an inflexible method or system of computing a reasonable depreciation deduction, but rather requires its determination in such fashion as will conform to the circumstances of the depreciated property and the enterprise within and for which the property is used. Clearly, a reasonable allowance for depreciation, within the revenue laws, depends upon the particular facts of each case.

In keeping with the purpose of the depreciation deduction and the established rules regarding its computation, the Commissioner contends that, for the purpose of computing a reasonable depreciation allowance pursuant to Section 23(l), the estimated useful life over which an asset is to be depreciated by a taxpayer is not necessarily the useful life inherent in the asset, and in the present case is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business. Similarly, it is submitted that salvage value, as that term is used in the Treasury Regulations interpreting Section 23(l), means the amount (determined at the time of acquisition) which it is reasonable to estimate will be realizable upon the sale or other disposal of the asset when it is no longer useful in a taxpayer's business and is retired from service.

Under the particular facts of this case, in which obsolescence is an important factor, the Tax Court was clearly correct in determining that a reasonable deduction is allowed taxpayer, for the taxable years 1950-1951, by computing the depreciation of his automobiles upon the basis of their useful life in his business as a lessor of rental-cars, and in taking into consideration in such computation, as salvage value, the substantial resale value which the cars possess in the used car market, and which taxpayer recovers upon the sale of the automobiles after they are no longer useful in his business. The Tax Court was correct in rejecting taxpayer's scheme of depreciating his automobiles upon the basis of their alleged inherent physical life, taking into consideration no salvage value, or possibly only a nominal scrap or junk value, since such a computation of depreciation is not in accord with the facts of this case and thus results in an unreasonable depreciation deduction which substantially distorts the taxpayer's net income subject to tax.

Numerous judicial decisions construing and applying Section 23(l), and the Treasury Regulations and Bulletin "F" interpreting that section, support the Tax Court's determination that the estimated useful life of taxpayer's automobiles for purposes of depreciation is not the inherent physical life of the automobiles, but is the period over which the automobiles may reasonably be expected to be useful to the taxpayer in his trade or business; and that salvage value is the amount which it is estimated will be realizable upon the sale of the automobiles when they are no longer useful in the taxpayer's business. There is substantial evidence in this record which supports the Tax Court's findings that, during the two years involved, the taxpayer's automobiles, when used for short-term rental purposes in his business, had an estimated useful life of fifteen months and a salvage value of $1,375; and when used for extended-term lease purposes in his busines, had an estimated useful life of three years and a salvage value of $600.

The depreciation deduction which the Tax Court's opinion allows to the taxpayer is in full accord with Section 117(j) of the 1939 Code, which permits capital gain upon the sale or exchange of certain property used in trade or business. Section 117(j) must be interpreted and applied in conjunction with Section 23(l)'s allowance of a reasonable depreciation deduction, since the cost basis which is used to determine capital gain under Section 117(j) is the original cost of the asset less the depreciation deducted therefrom. The effect which the Tax Court's opinion has upon taxpayer's capital gains stems solely from the fact that the court has followed Congress' direction to permit the deduction of only a reasonable allowance for the exhaustion, wear, tear and obsolescence of taxpayer's automobiles during the taxable years involved.

ARGUMENT

The Tax Court Correctly Computed Taxpayer's Depreciation Allowance, Under Section 23(l) of the Internal Revenue Code of 1939, On the Automobiles Used In His Car-Rental Business.

A. *Basic Principles.*

Section 23(l) of the Internal Revenue Code of 1939 (Appendix A, *infra*) permits, as a deduction in computing net income:

> A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

Thus, the statute authorizes the deduction of a *reasonable* allowance for depreciation. It is our position that, as the Tax Court held, a reasonable allowance on the automobiles used in taxpayer's business results only when the allowance is computed with reference to taxpayer's long-standing and well-established business experience and practice as a lessor in the car-rental business and, accordingly, that his depreciation deductions for the taxable years are to be computed on the basis of the estimated actual depreciation in the cars over their useful life *in taxpayer's business*, taking into account the estimated resale value of the cars at the end of that period. Taxpayer is not entitled to convert ordinary income into capital gain through the depreciation deduction.[3]

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[3] By ignoring the purpose of the depreciation expense deduction and the well-established rules governing its use,

Because of the nature of taxpayer's business, it is clear that obsolescence, rather than physical exhaustion, was the principal factor in the depreciation of

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taxpayer attempts to place himself in the anomalous position of being able to substantially reduce his income tax by substantially increasing his gross income. Strictly speaking, taxpayer reduces his net ordinary income by taking an unduly large depreciation deduction which, due to the fact that taxpayer consistently uses his automobiles for only a short period of time and recovers a large portion of their value upon their disposal to used car dealers, sets the stage for a large capital gain upon the sale of the excessively depreciated automobiles. An illustration of this procedure in operation can be given by using the findings of the Tax Court based on taxpayer's tax returns for the years 1950 and 1951. (R. 26, 28-29.) The following figures are approximate averages:

Year	Ordinary Income Per Car Over a 15-month Period	Depreciation Deduction Per Car Claimed	Cost Per Car	Sales Price Per Car	Actual Decrease In Value Per Car To Taxpayer	Capital Gain Per Car Claimed	Cars Sold
1950	$ 675	$ 515	$ 1,650	$ 1,380	$ 270	$ 245	140
1951	$ 675	$ 450	~~$ 1,459~~ $ 1,495	$ 1,395	$ 100	$ 350	147

As this case indicates, the tax which taxpayer pays on the capital gain at the low capital gain rate is more than overbalanced by the savings in the tax on his ordinary income which is taxed at the individual ordinary income rates. The key to this device is success in ignoring the resale value, *i.e.*, salvage value, of the cars. To ignore salvage value, taxpayer has to base his depreciation rate, not on the experience in his business, but rather on the hypothetical assumption most of his automobiles.[4] (R. 7, 69, 79-80.) As the Tax Court found (R. 28), the customers of U-Drive "demanded late model automobiles that were currently in style." (See R. 80.) Thus, in order to remain competitive, taxpayer has found it consistently necessary, at least since 1949, to dispose of the cars used in his business for short-term rental purposes after fourteen to sixteen months' use, and acquire as replacements new current model cars. (R. 46, 80.) Likewise, in the case of extended-term lease cars, it was the taxpayer's consistent practice to provide a new car at the beginning of the lease and dispose of it at the termination of the lease. (R. 64-65.) These leases, and consequently taxpayer's use of those cars in his business, averaged between eighteen and thirty-six months in duration. (R. 45, 80.) Taxpayer has testified and, the Tax Court found, that when taxpayer sold his cars they were generally in good physical condition (R. 27, 54), many "barely 'broken in'" (R. 32). Indeed, Mr. Bernard Verhey, one of the used car dealers who consistently bought

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that he uses his cars for their full physical life, allegedly four years. See Rabkin & Johnson, Federal Income Gift and Estate Taxation, Section 45.01, pp. 4504-4505.

[4] This, of course, is particularly true of the short-term rental cars which were held fourteen to sixteen months in taxpayer's business and constituted between 60 and 70% of all of taxpayer's cars. (R. 27, 79.) As to the extended-term lease cars, which were held by taxpayer between eighteen and thirty-six months, it appears that obsolescence, although important, was less of a factor in the depreciation of the cars, and the Tax Court's opinion takes this fact into account by dealing with the two types of cars separately.

cars from taxpayer, testified that "I found his cars to be in very fine shape." (R. 58.) It was taxpayer's established and continuing practice to sell his cars to used car dealers, jobbers or brokers at the wholesale price for cars in average or above average condition. (R. 47-49, 58-59.)

The basic and sole standard which Congress has laid down in Section 23(l) is the requirement that the yearly depreciation deduction *reasonably* reflect that portion of the value of the capital assets consumed in earning the gross income for the taxable year. *United States* v. *Ludey*, 274 U. S. 295, 300-301; *Virginian Hotel Co.* v. *Helvering*, 319 U. S. 523, 528; Treasury Regulations 111, Sections 29.23(l)-1, 29.23(l)-2, 29.23(l)-5 (Appendix A, *infra*). Section 23(l) also clearly requires that the deduction be based upon and take into consideration depreciation caused by economic forces, *i.e.*, obsolescence, as well as exhaustion of the assets caused by physical wear and tear.[5] *Gambrinus Brewery Co.* v. *Anderson*,

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[5] In Graham and Dodd, Security Analysis, Principles and Technique (2d ed.), p. 485, it is pointed out that to a large extent in practice "the *long term depreciation* factor is in reality overshadowed and absorbed by the *obsolescence* hazard." (Emphases in the original.) Likewise, the authors of Finney and Miller, Principles of Accounting, Intermediate (4th ed.), in examining from an accounting viewpoint the problem of the estimated life of tangible assets for depreciation purposes, state (p. 442):

> Estimating the life of a fixed asset requires consideration of both physical depreciation and obsolescence. The period during which the cost (or other base) should be absorbed in operations should be the probable physical life or the probable life prior to retirement caused

282 U. S. 638, 645; *Becker* v. *Anheuser-Busch, Inc.*, 120 F. 2d 403, 412 (C. A. 8th), certiorari denied, 314 U. S. 625.

The legislative reasoning behind the depreciation deduction is, of course, the determination that the federal income tax should be levied only upon gain and that a reasonable amount allowed to be set aside through the depreciation deduction is not gain, but is capital that has gone into gross income. As the Supreme Court has stated in *Gambrinus Brewery Co.* v. *Anderson*, *supra*, pp. 642-643:

> The cost of plant depreciation, i.e., exhaustion, wear, tear and obsolescence, is a part of operating expenses necessary to carry on a manufacturing business. The gain or loss in any year cannot be rightly ascertained without taking into account the amount of such cost that is justly attributable to that period of time.
>
> The history of § 234 (a) (7) discloses a legislative purpose that the amount reasonably attributable to each year on account of obsolescence of tangible property used in the taxpayer's business is to be taken into account in ascertaining his taxable income.[6]

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by obsolescence, whichever is less. Plates used in the printing of a book may be in usable condition long after the sale of the book has ceased, but their cost should be charged to operations during the period when sales are made. Patterns and molds, although physically usable for years, may have a life for production purposes only during the manufacture of one annual model.

[6] Sections 234 (a) (7) and 214 (a) (8) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, are respectively depreciation sections for corporate and individual income. Both are predecessor sections of Section 23(l) of the 1939 Code.

See also, *United States* v. *Ludey*, supra, pp. 300-301; *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98, 101-102; *Commissioner* v. *Moore*, 207 F. 2d 265, 275 (C. A. 9th), certiorari denied, 347 U. S. 942; *Union Bleachery* v. *United States*, 73 F. Supp. 496, 502 (W. D. S. C.), affirmed, 176 F. 2d 517 (C. A. 4th), certiorari denied, 339 U. S. 964; *United States* v. *Milnor Corp.*, 85 F. Supp. 931, 938 (E. D. Pa.).

Moreover, it is axiomatic that "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities" (*Helvering* v. *Lazarus & Co.*, 308 U. S. 252, 255), and that a reasonable allowance for depreciation, within the revenue laws, depends upon the peculiar facts of each case (*Pittsburgh Hotels Co.* v. *Commissioner*, 43 F. 2d 345, 347 (C. A. 3d)). "The statute [Section 23(l)] does not provide for an inflexible method or system of computing depreciation but appears clearly to allow its determination in such fashion as will conform to the circumstances of the depreciated property and the enterprise within and for which it is owned and used." *Koelling* v. *United States* (Neb.), decided February 14, 1957 (1957 P-H, par. 72, 529).

In the large majority of cases depreciable property is held by taxpayers over its useful *physical* life and there is little question as to the proper depreciation allowance but, where there is a pattern of use of property for a given period and resale at a substantial price at the end of that period, a different method conforming to the facts is required. Depreciation is designed to permit tax-free recovery of that portion of the "unrecovered" cost or other basis of the property which may "reasonably be considered necessary." Treasury Regulations 111, Section 29.23(l)-5 (Appendix A, *infra*). Thus, Section 29.23(l)-1 of the Regulations (Appendix A, *infra*), specifically provides that the projer allowance for depreciation is the amount which should be set aside for the taxable year in accordance with a reasonably consistent plan—

> whereby the aggregate of the amounts so set aside, plus the *salvage value*, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. * * * (Italics supplied.)

Necessarily, in initially setting up the amount of the depreciation allowance, the length of the useful life of the asset and the amount of the salvage value thereof are estimated at the time of the acquisition of the asset upon reasonably predictable conditions. It would obviously be unduly rigid and totally unrealistic, however, to require that, once the original estimate had been made by the taxpayer, the parties would be irrevocably bound thereby in computing the amounts of the subsequent annual depreciation expense allowances.[7] *Terminal Realty Corp.* v. *Commissioner*, 32 B. T. A. 623, 629. Accordingly, it is generally accepted and recognized that the reason-

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[7] Cf. Section 41 of the 1939 Code (26 U. S. C. 1952 ed., Sec. 41) which provides that if the taxpayer's method of accounting does not clearly reflect net income "the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

ableness of the depreciation deduction claimed is to be determined in the light of conditions known to exist at the end of the tax year for which the return is made. *Commissioner* v. *Mutual Fertilizer Co.*, 159 F. 2d 470 (C. A. 5th); *Automatic Cigarette Sales Corp.* v. *Commissioner*, decided January 25, 1955 (1955 P-H. T. C. Memorandum Decisions, par. 55,015), affirmed without discussion of this point, 234 F. 2d 285 (C. A. 4th); *Koelling* v. *United States* (Neb.), decided February 14, 1957 (1957 P-H., par. 72,529); *Leonard Refineries, Inc.* v. *Commissioner*, 11 T. C. 1000, 1006-1007; *Weir Long Leaf Lumber Co.* v. *Commissioner*, 9 T. C. 990, 998, reversed on other grounds, 173 F. 2d 549 (C. A. 5th); [8] Treasury Regulations 111, Section 29.23(l)-5. Cf. *Commissioner* v. *Superior Yarn Mills*, 228 F. 2d 736 (C. A.

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[8] As stated in *Weir Long Leaf Lumber Co.* v. *Commissioner, supra,* p. 998:

> It has long been the rule that depreciation deductions are to be corrected in any year when it is apparent that the factor involving the extent of useful life is erroneous (see *e.g., Washburn Wire Co.* v. *Commissioner* (C. C. A., 1st Cir.), 67 Fed. (2d) 658), and that the reasonableness of a deduction for depreciation is to be determined upon conditions known to exist at the end of the period for which the return is made. Regulations 111, sec. 29.23(1)-5. See *Commissioner* v. *Mutual Fertilizer Co.* (C. C. A., 5th Cir.), 159 Fed. (2d) 470. An adjustment to correct for mistaken salvage value is no different from an adjustment of a mistaken estimate of years of use. In this manner depreciation can be kept to an accurate provision for the return of petitioner's capital investment in the property. This is what the law contemplates. See *Helvering* v. *Virginian Hotel Corporation,* 319 U. S. 523.

4th).[9] The Commissioner is not only authorized but is required by the intent of Section 23(l) of the 1939 Code, the Treasury Regulations, and judicial decisions to determine depreciation on the basis of the facts of the particular business involved. *Detroit Edison Co.* v. *Commissioner, supra,* pp. 101-102; *Washburn Wire Co.* v. *Commissioner*, 67 F. 2d 658, 660 (C. A. 1st); *Geuder, Paeschke & Frey Co.* v. *Commissioner*, 41 F. 2d 308, 310 (C. A. 7th); Treasury Regulations 111, Section 29.23(l)-5.

Thus, the Commissioner contends that for the purpose of Section 23(l) the estimated useful life of an asset is not necessarily the useful life inherent in the asset, and that in the present case it is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business, or in the production of income. Likewise, it is submitted that salvage value, as that term is used in the Treasury Regulations and as applied to the present case, means the amount (determined at the time of acquisition) which is estimated will be realizable upon the sale or other disposal of an asset when it is no longer useful in the taxpayer's trade

[9] In *Commissioner* v. *Superior Yarn Mills, supra* it was held that an allocation of actual cost as between depreciable and non-depreciable property, originally made in 1929 when the property was purchased, could be revised in a later year (1944) in the light of intervening events. Since an adjustment to correct a mistaken *original cost* figure may be justified, *a fortiori* an adjustment made in the light of conditions known to exist at the end of the tax years 1950 and 1951 for a grossly erroneous prediction of useful life and salvage value may be made.

or business, or in the production of his income, and is to be retired from service by the taxpayer.[10]

Contrary to the taxpayer's argument (Br. 12, 19, 31), the Commissioner recognizes that in many factual situations (unlike that in the instant case), where the evidence indicates that an asset will probably be used for its full physical life in a taxpayer's business or where, upon the basis of the taxpayer's business experience and practice, this is the only reasonable prediction which can be made, the estimated useful life of an asset for the depreciation computation will be the physical or inherent life of the asset, and salvage value will be a nominal scrap value. Such a computation, of course, must also be bottomed on a finding that, after taking all the facts into consideration, the computation of depreciation upon the basis of an inherent or physical useful life will not

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[10] The taxpayer incorrectly states (Br. 12) that:

> The Commissioner wishes, rather, to disregard the fact that the asset has years of useful life left after the taxpayer sells it. He wants to lower an iron curtain at the end of the period of the taxpayer's use of the property, and to limit his recognition of "useful life" solely to the partial life of the assets in the hands of the first user.

Of course, when taxpayer's automobiles are resold by the used car dealers, it must be assumed that many of them will be used for personal pleasure and will not qualify for the depreciation deduction. However, as to those cars which are used for business purposes, the cost of the used car, less salvage value, will be subject to the depreciation deduction. Probably in such cases the facts will usually warrant using, as the useful life of the car for depreciation purposes, the remaining physical life of the car.

produce an unreasonable depreciation deduction in the particular case.

The taxpayer here, on the other hand, in effect insists that depreciation is a fixed and frozen concept based upon one rigid formula which, as indicated by this case, may be divorced from the realities of a business.[11] He contends that "useful life" in every case must be considered, for depreciation purposes, as being coterminous with the inherent physical life of an asset for business purposes, and that salvage value necessarily means scrap or junk value at the end of an asset's physical life, in this particular case, computed to be zero.

B. ***In the light of taxpayer's established business experience and practice, the Tax Court was clearly correct in holding that a reasonable depreciation is allowed taxpayer by depreciating the automobiles over their useful economic life in taxpayer's business as distinguished from the physical life of the automobiles.***

1. *The depreciation of taxpayer's automobiles over their useful economic life in taxpayer's business is fully supported by the Treasury Regulations and Bulletin "F".*

As taxpayer recognizes (Br. 12-13), Treasury Regulations 45, Article 161, construing Section 214

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[11] However, in *Detroit Edison Co.* v. *Commissioner, supra,* the Supreme Court, in discussing the purpose of depreciation, has stated that (pp. 101-102):

> The calculation is influenced by too many variables to be standardized for differing enterprises, assets, conditions, or methods of business. The Congress wisely refrained from formalizing its methods and we prescribe no over-all rules.

(a) (8) of the Revenue Act of 1918,[12] c. 18, 40 Stat. 1057, provided:

> The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts *for the useful life of the property in the business* will suffice, with the salvage value, at the end of *such useful life* to provide in place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date. (Emphases added.)

Similar language was used in the Regulations through Treasury Regulations 103, Section 19.23(l)-1, construing Section 23(l) of the 1939 Code.[13] In Treasury Regulations 111, Section 29.23(l)-1, applicable to years beginning after December 31, 1941, the phrase "in the business" was left out. Taxpayer argues (Br. 13-14) that such omission is an indication that the Commissioner had abandoned the interpretation of "useful life" as set forth in the earlier Regulations and as applied by the Tax Court in this case. Such

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[12] Section 214(a) (8) is substantially similar to Section 23(l) of the 1939 Code.

[13] Treasury Regulations 62, Article 161, Revenue Act of 1921; Treasury Regulations 65, Article 161, Revenue Act of 1924; Treasury Regulations 69, Article 161, Revenue Act of 1926; Treasury Regulations 74, Article 201, Revenue Act of 1928; Treasury Regulations 77, Article 201, Revenue Act of 1932; Treasury Regulations 86, Article 23(l)-1, Revenue Act of 1934; Treasury Regulations 94, Article 23(l)-1, Revenue Act of 1936; Treasury Regulations 101, Article 23(l)-1, Revenue Act of 1938.

an interpretation, however, is clearly incorrect. As a result of the Supreme Court's decision in *Higgins* v. *Commissioner*, 312 U. S. 212, which held that investment management expenses were not deductible under Section 23(a) of the Revenue Act of 1932, c. 209, 47 Stat. 169, because not incurred in carrying on any trade or business, Congress enacted Section 121(c) of the Revenue Act of 1942, c. 619, 56 Stat. 798, which amended Section 23(l) of the 1939 Code by adding "or (2) of property held for the production of income." T. D. 5196, 1942-2 Cum. Bull. 97, 100, clearly shows that:

> In order to conform Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] to Sections 121 and 161 of the Revenue Act of 1942 (Public Law 753, Seventy-seventh Congress), approved October 21, 1942, such regulations are amended as follows:
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> * * * *
>
> Par. 4, Section 19.23(l)-1 is amended as follows:
>
> (A) By inserting after "business" in the first sentence the following:
>
> or treated under section 19.23(a)-15 as held by the taxpayer for the production of income.
>
> (B) By changing the third sentence to read as follows:
>
> The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so

> set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113.

Thus, the only reason for deleting the phrase "in the business" was to give the Regulations broader application, *i.e.*, to depreciation "of property held for the production of income." The Commissioner clearly did not abandon any former interpretation regarding the useful life of property subject to depreciation.

In Section 167 of the Internal Revenue Code of 1954 (26 U.S.C. 1952 ed., Supp. II, Sec. 167), Congress authorized several new methods for computing depreciation, as well as certain limitations on the use of those methods. However, Section 167(a) of the 1954 Code, the basic depreciation provision, is, in substance, exactly the same as Section 23(l) as amended by Section 121(c) of the Revenue Act of 1942, the section of the 1939 Code applicable to the tax years here involved. The legislative history of Section 167(a) clearly shows that Congress intended no change as far as the basic depreciation provision set forth in Section 23(l) is concerned.[14] In Treasury Regulations on Depreciation (1954 Code), Section 1.167(a)-1 (T. D. 6182, 1956-1 Cum. Bull. 99), the Treasury Department goes into detail in defining the term "useful life," and emphasizes a taxpayer's own practices as against purely objective physical life ex-

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[14] See H. Rep. No. 1337, 83d Cong., 2d Sess., p. A 48 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4184); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 200 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4835-4836).

pectancies. See Section 1.167(a)-1(b), Appendix B, *infra.* This definition of useful life of property for depreciation purposes, which the Commissioner submits has been his interpretation since Treasury Regulations 45, Article 161, fully supports the decision of the Tax Court in this case.

Further evidence, if any is needed, of a consistent interpretation of the concept of useful life supporting the Tax Court's opinion is contained in Bulletin "F", Bureau of Internal Revenue (Revised January, 1942). In Bulletin "F" it is stated (p. 2):

> The proper allowance for exhaustion, wear and tear, including obsolescence, of property used in trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of *the useful life of the property in the business*, equal the cost or other basis of the property. In no instance may the total amount allowed be in excess of the amount represented by the difference between the cost or other allowable basis and the salvage value which reasonably may be expected to remain at the end of the useful life of the property in the trade or business. (Emphasis added.)[15]

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[15] The following provisions of Bulletin "F" also support the Tax Court's opinion in this case (p. 3):

> PROBABLE USEFUL LIFE—RATES OF DEPRECIATION AND OBSOLESCENCE
>
> *In general.* The amount of the annual deduction allowable for depreciation is ordinarily dependent upon

Taxpayer points out (Br. 15) that in Bulletin "F" (p. 52) it is stated that the average useful life of an automobile in commercial use is three or five years, depending on the use of the car. It should be noted, however, that the estimated average useful lives listed in Bulletin "F" (Revised January, 1942) are simply

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the expected useful life of the asset. The factors which determine the useful life of property in a trade or business have already been discussed briefly in the introduction. These factors are wear and tear and decay or decline from natural causes; and also various forms of obsolescence attributable to the normal progress of the art, economic changes, inventions, and inadequacy to the growing needs of the trade or business. Two principal forms or types of obsolescence are generally recognized, that is, normal obsolescence and extraordinary or special obsolescence.

Normal obsolescence is caused by factors which can be anticipated with substantially the same degree of accuracy as other ordinary depreciation factors, such as wear and tear, corrosion or decay. Accordingly, it is included in estimating the normal useful life of depreciable property, the effect of which is to include the allowance for normal obsolescence in the depreciation deduction.

* * * *

Past experience, which is a matter of fact and not of opinion, coupled with informed opinion as to the present condition of the property, and current developments within the industry and the particular trade or business, furnish a reliable guide for the determination of the useful life of the property. Such a determination should reflect all the peculiar circumstances of the use or operation of the property, such as the purpose for which it is utilized, the conditions under which it is used or operated, the policy as to repairs, renewals, and improvements, and the climatic and other local conditions.

the result of engineering studies conducted prior to January, 1942, based upon "average" conditions in an industry. They are simply rules of thumb. The provisions of Bulletin "F" referred to herein clearly show that in applying the average useful lives one must also take into consideration the particular facts and circumstances of the individual case.[16] As we have pointed out, the economic usefulness of automobiles in taxpayer's business was unusually short.

Taxpayer also relies on an office decision and two revenue rulings of the Internal Revenue Service. (Br. 14, 16-17.) The general proposition quoted from O. D. 845, 4 Cum. Bull. 178 (1921), supports the Tax Court's opinion.[17] In reading the office decision, tax-

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[16] It should be noted that the title page of Bulletin "F" (Revised January, 1942) states that the bulletin—

> does not have the force and effect of a Treasury Decision and does not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury.
>
> Taxpayers and officers of the Bureau are cautioned against reaching conclusions in any case solely on information contained herein and should base their judgment on the application of all pertinent provisions of the law, regulations, and other Treasury Decisions to all the facts in any particular case. The estimated useful lives and rates of depreciation indicated in this bulletin are based on averages and are not prescribed for use in any particular case. They are set forth solely as a guide or starting point from which correct rates may be determined in the light of the experience of the property under consideration and all other pertinent evidence.

[17] O. D. 845, 4 Cum. Bull. 178 (1921), actually deals with the depreciation of buildings under construction.

payer overlooks the fact that his cars were acquired for rental-car purposes and have a short useful life in that business. As for Rev. Rul. 108, 1953-1 Cum. Bull. 185, and Rev. Rul. 54-229 1954-1 Cum. Bull., 124, those rulings deal with "Gains and losses from involuntary conversions and from the sale or exchange of certain property used in the trade or business." It should be noted that, contrary to taxpayer's assertion (Br. 16), Rev. Rul. 108, only inferentially deals with depreciation, and Rev. Rul. 54-229 does not deal with that issue at all. We submit that the Commissioner's use of the term "useful life" when dealing with a different legal issue sheds no light on the question presented by this case.

2. *The depreciation of taxpayer's automobiles over their useful economic life in taxpayer's business is fully supported by judicial decision.*

The basic principles of depreciation upon which the Tax Court based its opinion in this case have long been established in tax law. In the case of *United States* v. *Ludey*, 274 U. S. 295, which deals, in part, with the depreciation and depletion deduction,[18] the Supreme Court stated (pp. 300-301):

> The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant

[18] Contrary to the taxpayer's contention (Br. 38), the nature and purpose of the depreciation deduction was briefed and argued in the *Ludey* case, No. 289, October Term, 1926.

> used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, *at the end of the useful life of the plant in the business*, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. (Emphasis added.)

The term "useful life" of an asset, for purposes of depreciation, was also stated to mean the useful life of the asset "in the business" in *Burlington Gazette Co.* v. *Commissioner*, 75 F. 2d 577, 578 (C. A. 8th); *Cameron* v. *Commissioner*, 56 F. 2d 1021, 1023 (C. A. 3d); *Becker* v. *Anheuser-Busch, Inc.*, 120 F. 2d 403, 412 (C. A. 8th), certiorari denied, 314 U. S. 625. In the recent case of *Cohn* v. *United States* (W. D. Tenn.), decided February 25, 1957 (1957 P-H par. 72,573), on appeal C. A. 6th, the rate of depreciation of certain flying-school equipment was involved. Due to the particular circumstances of the case, "the method and rate of depreciation used by the three civilian contract flying schools was based upon the useful economic life of the equipment in the business." The flight-training schools did not, however, take into account the salvage value of the moveable equipment in determining depreciation. The District Court held, with respect to the question of useful life, that, in circumstances where it can reasonably be ascertained that equipment will no longer be useful to the business at a certain time, the proper method is to depreciate the property to the date of such occurrence; and that taxpayers, in depreciating the equipment over the period of its estimated useful economic life in the business, used a reasonable method under the circumstances.[19] The court then went on and held that the taxpayers erred in not including a salvage value of 10% of original cost in the depreciation computation, since the equipment, at the end of its period of usefulness to taxpayers, had considerable resale value "in the open market" which could have reasonably been estimated at the end of each of the four taxable years in question.[20] Since salvage value is merely the estimated amount which will be realizable upon the sale or other disposition of an asset when it is no longer useful in the taxpayer's business and is retired from service by the taxpayer, it follows that cases dealing with the question of the amount of salvage value to be taken into consideration in computing depreciation often indirectly deal with the question of the useful life of the asset in the business. The salvage value cases will be discussed in detail in Point II.

In its opinion, the Tax Court cited the case of *McWilliams* v. *Commissioner*, 15 B. T. A. 329, 344-345, a case dealing with the depreciation of auto-

[19] The District Court cited the cases of *U. S. Cartridge Co.* v. *United States,* 284 U. S. 511; *Burnet* v. *Niagara Brewing Co.,* 282 U. S. 648, and *Gambrinus Brewing Co.* v. *Anderson,* 282 U. S. 638. These cases deal with the obsolescence factor of the depreciation deduction, a factor which is also of major importance in the depreciation of taxpayer's automobiles.

[20] The taxpayers have appealed to the United States Court of Appeals for the Sixth Circuit only on the salvage value issue. The Commissioner did not appeal.

mobiles over their useful life in a taxpayer's business. The taxpayer attempts (Br. 42-43) to distinguish the case by limiting it to its particular facts. We, of course, recognize that a reasonable allowance for depreciation depends upon the peculiar facts of each case. *Pittsburgh Hotels, Co.* v. *Commissioner*, 43 F. 2d 345, 347 (C. A. 3d); *Washburn Wire Co.* v. *Commissioner*, 67 F. 2d 658, 660 (C. A. 1st); *Geuder, Paeschke & Frey Co.* v. *Commissioner*, 41 F. 2d 308, 310 (C. A. 7th). However, the case does show that, in the particular facts of a case, depreciation of an asset over its useful economic life in a business results in a reasonable depreciation allowance.[21] In the case of the depreciation of buildings, the courts have often noted that the useful economic life of a building in a business may be much shorter than the building's physical life; and, in such case, depreciation is computed over the building's economic life to the taxpayer. *Adda, Inc.* v. *Commissioner*, 9 T. C. 199, 209-210, affirmed on another issue, 171 F. 2d 367 (C. A. 2d); *First National Bank In Mobile* v. *Commissioner*, 30 B. T. A. 632; *Kent* v. *Commissioner*, decided December 31, 1953 (1954 P-H T. C. Memorandum Decisions, par. 54,011).

Taxpayer cites (Br. 17-24) a number of cases where apparently an asset was depreciated by a taxpayer on the basis of its physical life as distinguished

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[21] As to the depreciation of the sawmill in *McWilliams* v. *Commissioner, supra,* the case simply indicates that the evidence in the particular case warranted computing depreciation of the mill on the basis of its physical life instead of its life in the taxpayer's business.

from its useful life in the taxpayer's business.[22] The Commissioner recognizes that such a method of depreciation is often warranted if it does not produce an unreasonable depreciation allowance. Since each of the cases turns on its own particular facts, they do not establish a binding precedent for this case. In many of the cases, the facts are only briefly stated and the issue is summarily dealt with as one of fact. For example, in the cases of *Sanford Cotton Mills* v. *Commissioner*, 14 B. T. A. 1210; *Markle Brown Co.* v. *Commissioner*, 3 B. T. A. 1084; *Kurtz* v. *Commissioner*, 8 B. T. A. 679; and *General Securities Co.* v. *Commissioner*, decided March 9, 1942 (1942 P-H T. C. Memorandum Decisions, par. 42,219), the usual company car or truck situation was involved. The opinions indicate that physical wear and tear was the primary factor in the depreciation of the cars or trucks, and depreciation based on the physical life of the asset was found not to be unreasonable. On the other hand, in this case, the taxpayer's cars (particularly the short-term rental cars) are used in such a way that obsolescence is the principal factor involved and, as indicated, depreciation of the asset on a basis of a four-year physical life creates an unreasonable depreciation allowance in this particular case. Tax-

[22] Most of the cases are Board of Tax Appeals or Tax Court opinions. Taxpayer cited many of the cases in his brief in the Tax Court. The Tax Court, which certainly is familiar with the holdings in its own opinions, apparently did not consider the opinions controlling on the issues presented by this case. We submit that an examination of the cases shows that they are not controlling here.

payer's reliance on the case of *Philber Equipment Corp.*, v. *Commissioner*, 237 F. 2d 129 (C. A. 3d), and the Commissioner's brief filed therein, is also misplaced. An examination of the opinion in that case shows that there was a single issue before the court relating to capital gain on the sale of motor vehicles at the end of the period of various leases. The issue of depreciation, or useful life and salvage value for purposes of depreciation, was not presented or passed upon. The language which taxpayer quotes from the opinion and brief (Br. 23) involves a discussion of a different legal issue and throws no light on the meaning of the term "useful life" for depreciation purposes. Likewise, the case of *Pilot Freight Carriers, Inc.* v. *Commissioner*, decided August 27, 1956 (1956 P-H T. C. Memorandum Decisions, par. 56, 195), does not set forth a legal principle controlling in the present case. In that case, the issue was factual, *i.e.*, the useful life of certain motor freight transportation equipment. There was no question of salvage value before the court. The taxpayer contended that its equipment was disposed of after it had passed the age of economic usefulness. The Commissioner had determined a longer useful life than that used by the taxpayer. The Tax Court found the useful lives to be slightly more than contended for by the taxpayer.

The case of *Massey Motors, Inc.* v. *United States*, 156 F. Supp. 516 (S. D. Fla.), presents a factual situation somewhat analogous to this case. The court's opinion on the depreciation issue, however, is in conflict with *Goldberg* v. *Commissioner*, 239 F. 2d 316 (C. A. 5th). The Commissioner considers that on the depreciation issue the District Court's opinion in *Massey* is erroneous, and an appeal is being taken on that issue to the United States Court of Appeals for the Fifth Circuit. The case of *Estate of Whitaker* v. *Commissioner*, 27 T. C. 399, 405-406, deals with a question of accelerated depreciation. Because of a leg injury, the useful life of a certain race horse, *i.e.*, its useful life to taxpayer as a race horse, was shortened. The horse's useful life to the taxpayer was not shortened because of wear and tear, but rather because of a non-recurring accidental injury. For this reason, accelerated depreciation was denied. It should also be noted that in the depreciation computation the taxpayer correctly took into consideration the $1,000 for which he sold the horse. The $1,000 clearly was not the scrap or junk value of the horse. The case clearly supports the Tax Court's opinion in this case.

3. *The Tax Court correctly rejected opinion evidence regarding the law applicable to this case.*

Finally, the taxpayer relies (Br. 25-26) on the testimony of two certified public accountants who testified as to their personal opinions on the law applicable to this case (R. 84, 89). We submit that the Tax Court was not bound by the personal opinions of taxpayer's accountants, and was clearly correct in rejecting their interpretation of the law of this case.[23]

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[23] The Commissioner objected to the opinion testimony of Mr. Paul Johnson, the first of taxpayer's "experts" to testify. (R. 86.) The court permitted the evidence to go into the

The District Court in *Koelling* v. *United States* (Neb.), decided February 14, 1957 (1957 P-H, par. 72,529), in dealing with similar expert testimony on depreciation by an Internal Revenue Agent, lawyers, and an accountant, correctly states:

> The fact that in the general area comprising the residence and operating location of a taxpayer a custom has grown up among taxpayers of computing income in a particular manner is neither controlling nor instructive in support of the taxpayer's observance of that custom in the preparation of his return. What matters is whether the method he employs is correct. Testimony of the sort tendered might easily have materiality if the issue were the good faith of the taxpayer in his following of the method. But that is not the present question, which is rather the validity on its own account of the method itself. The court is, accordingly, uninfluenced in its ruling by paragraphs numbered 29 and 30 of the stipulation, or either of them.

Contrary to taxpayer's assertion (Br. 26), the knowledge of taxpayer's experts regarding the Treas-

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record but stated that "I know it is not controlling. I am not going to let it control me". (R. 86.) It is well established that expert opinion testimony on domestic law, as distinguished from expert testimony on foreign law, is excludable under the so-called opinion rule. See Wigmore, Evidence (3d ed.), Section 1952. It is the function of the judge (or the jury as instructed by the judge) to determine the law applicable to the case. Wigmore states (Section 1954) that even in giving opinion testimony on trade usage "the witness should state the tenor of the usage or practice, omitting any reference to the legal effect."

ury Regulations and Bulletin "F" was shown to be somewhat limited. On cross-examination (R. 91), Mr. Raymond Hoffman confessed that he had no exact recollection as to whether the expression "useful life in the taxpayer's business" was used in the Treasury Regulations or Bulletin "F". As already pointed out, the expression "useful life of the property in the business" was expressly used in the Treasury Regulations from 1918 to 1942, is used in Bulletin "F", and the concept is presently spelled out in detail in the Treasury Regulations for the 1954 Code.

C. ***In the light of taxpayer's established business experience and practice, the Tax Court was clearly correct in holding that taxpayer must take into consideration in his depreciation computation the resale value of his automobiles which he recovers at the termination of their useful life in his business.***

It is basic that, in the computation of the annual allowance for depreciation, the cost of the property should first be reduced by the estimated salvage value thereof before applying the appropriate rate of depreciation. *Burnet* v. *Niagara Brewing Co.*, 282 U. S. 648, 655; *United States* v. *Ludey*, 274 U. S. 295, 300-301; *Goldberg* v. *Commissioner*, 239 F. 2d 316, 319 (C.A. 5th); *Cohn* v. *United States* (W. D. Tenn.), decided February 25, 1957 (1957 P-H, par. 72,573), on appeal, C. A. 6th; *Humphrey* v. *Commissioner*, decided January 18, 1946 (1946 P-H T. C. Memorandum Decisions, par. 46,004), affirmed without discussion on this point, 162 F. 2d 853 (C. A. 5th), certiorari denied, 332 U. S. 817; *W. H. Norris*

Lumber Co. v. *Commissioner*, decided October 12, 1948 (1948 P-H T. C. Memorandum Decisions, par. 48,204); *Davidson* v. *Commissioner*, decided September 24, 1953 (1953 P-H T. C. Memorandum Decisions, par. 53,317); *Bolta Co.* v. *Commissioner*, decided November 28, 1945 (1945 P-H T. C. Memorandum Decisions, par. 45,360, modified, par. 45,372); Treasury Regulations 111, Section 29.23 (l)-1.

The reason that salvage value must be taken into account in computing the annual depreciation allowance is clear. As pointed out, depreciation for tax purposes is the method whereby the part of the cost of an asset used up or lost annually in producing gross income is charged against the yearly period the asset is used to produce the income so as to arrive at net income subject to tax. To correctly estimate the amounts to be periodically charged to expense as depreciation, it is necessary, as the Regulations, courts, and accounting authorities recognize, to make allowance for the amount for which the asset may ultimately be sold when it has completed its usefulness to the business, *i.e.*, its "salvage value." It is the cost of the asset, less this salvage value, which is then amortized over the years that the asset is used. Salvage value is thus merely the estimated amount which will be realizable upon the sale or other disposition of the asset when it is no longer useful in the taxpayer's business and is to be retired from service by the taxpayer. *Burnet* v. *Niagara Brewing Co.*, *supra*, p. 655; *Goldberg* v. *Commissioner*, *supra*, p. 319.

It is apparent, contrary to taxpayer's assertions (Br. 28-30), that "salvage value" is not necessarily limited to "scrap" or "junk value." "Salvage value," may, as in this case, represent a high percentage of the asset's original cost. If it is estimated that the asset will be used by the taxpayer to the end of its intrinsic useful life, or if it is a specialized type of asset which is not readily salable, its "salvage value" might be no more than a "scrap value." See *Whitham* v. *Commissioner*, decided March 16, 1951 (1951 P-H T. C. Memorandum Decisions, par. 51,075); *Brown* v. *Commissioner*, 27 T. C. 27, 31, 36; Finney and Miller, Principles of Accounting, Intermediate (4th ed.), p. 442. On the other hand, if the asset will be disposed of long before its physical life has expired, probably will be in salable condition, and will be readily marketable, the salvage value may represent a large proportion of the original cost of the asset.[24]

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[24] In this connection, Bulletin "F" provides (p. 7):

> Salvage value is the amount realizable from the sale or other disposition of items recovered when property has become no longer useful in the taxpayer's business and is demolished, dismantled, or retired from service. When reduced by the cost of demolishing, dismantling, and removal, it is referred to as net salvage. In principle, the estimated net salvage should serve to reduce depreciation, either through a reduction in the basis on which depreciation is computed or a reduction in the rate. In either instance the amount of net salvage should actually, or in effect, be a credit to the depreciation reserve. Where the basis or rate for depreciation is not reduced for estimated salvage, all net receipts from salvage should be considered income.

See also *Cohn* v. *United States, supra*; *Davidson* v. *Commissioner, supra*; *Terminal Realty Corp.* v. *Commissioner,* See Treasury Regulations on Depreciation (1954 Code), Section 1.167(a)-1(c) (Appendix B, *infra*). The Supreme Court, in *Burnet* v. *Niagara Brewing Co.*, *supra*, p. 655, has stated that:

> In determining the proper deduction for obsolescence there is to be taken into consideration the amount probably recoverable, at the end of its service, by putting the property to another use or by selling it as scrap or otherwise. There is no hard and fast rule, as suggested by the Government, that a taxpayer must show that his property will be scrapped or cease to be used or useful for any purpose, before any allowance may be made for obsolesence.

In the case of *Goldberg* v. *Commissioner*, *supra*, the depreciation of motor vehicles and coin-operated equipment was involved. The Tax Court held that at the end of a three-year depreciation period, there was a salvage value of ten percent of the cost of the assets. In affirming, the Court of Appeals for the Fifth Circuit noted that (p. 319) "It was apparent that the equipment had a value in excess of what it would bring as scrap or junk. The Tax Court so found, and

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32 B.T.A. 623, 629; *Humphrey* v. *Commissioner*, *supra*. Thus, in either case (*i.e.*, whether by subtraction of the estimated salvage value from the cost of the asset to obtain the amount to be amortized annually, or by a reduction in the rate or percentage of depreciation to be applied to the cost of the asset), the effect is to reduce the annual amount of allowable depreciation, thereby adjusting depreciation to its true picture, since the true cost of the asset to the business is the cost less the amount ultimately to be received upon the disposal of the asset.

found the percentage of the salvage value." Likewise, in the case of *Cohen* v. *United States*, *supra*, the District Court held that the substantial resale value of certain aviation equipment had to be included in the taxpayers' depreciation computation as salvage value.

In two other cases, the Tax Court has required taxpayers to include as salvage value in the depreciation computation the substantial resale value of motor vehicles which it was estimated would be reasonably recovered upon the disposal of the car or truck when it was no longer useful in the business. In *W. H. Norris Lumber Co.* v. *Commissioner*, *supra*, the taxpayer depreciated its automotive equipment over a period of four years and included no salvage value. The Tax Court upheld the Commissioner's determination that in each of the taxable years it was apparent to the taxpayer that the automotive equipment would have a substantial resale value. In that case, the salvage value was estimated to be twenty percent of cost. In *Davidson* v. *Commissioner*, *supra*, a salvage value in the amount of twenty percent was also required for certain cars and trucks used in a construction business. The court found that, ordinarily, some of the taxpayer's construction equipment could only be disposed of as junk and that it could not, on the facts of the case, be reasonably estimated what the salvage value, if any, would be. However, the court found that, in view of the amounts being consistently recovered, it was apparent to the taxpayers that "its automobiles and trucks would have substantial salvage values at the end of the period over which the partnership was depreciating them." Under the circumstances of the case, a salvage value of twenty percent of cost was held to be conservative.

Another Tax Court case, *Bolta* v. *Commissioner*, *supra*, involved the depreciation of plastic injection machines which were used to make combs. After several years' use, a machine was no longer useful in the taxpayer's business for making combs, but was good for making other plastic articles which the taxpayer did not manufacture. Thus, the taxpayer used a machine for five years and then sold it, recovering a substantial portion of its cost. The taxpayer included no salvage value in the depreciation of the machines. The Tax Court, however, found that in this case, where the resale value could be reasonably estimated, a salvage value of twenty-five percent of original cost was required.

In arguing (Br. 28-30) that for purposes of depreciation the term "salvage value" can mean only "junk or scrap value," the taxpayer relies on the case of *Koelling* v. *United States* (Neb.), decided February 14, 1957 (1957 P-H, par. 72,529). His reliance is misplaced. An examination of the opinion shows that the principles which it enunciates clearly support the Tax Court's opinion here. In *Koelling*, the District Court stated that the basis for depreciation of a breeding herd of cattle was its cost less salvage value, rather than cost alone. The court considered unreasonable the deduction of the entire cost of the cattle through annual depreciation over the breeding life in the herd, since the court held that at the end of the useful breeding period the cattle still had a "substantial salvage value," either in the open livestock market or, in many instances, by way of resale to other breeders. This substantial sale value, the court found, was susceptible "to intelligent and practical computation."

D. ***The evidence in the record fully supports the Tax Court's findings of fact and opinion.***

Applying the foregoing principles to the facts of this case, it is clear that during the taxable years involved the taxpayer should have depreciated his short-term rental and extended-term lease cars over a useful life of respectively fifteen months and three years. It is also clear, on the facts of this case, that the reasonably estimable salvage value was that found by the Tax Court. We submit that there is substantial evidence in the record to support the findings of the Tax Court and, certainly, the findings cannot be said to be clearly erroneous.

The Supreme Court has stated that "It is well understood that exhaustion, wear, tear or obsolescence cannot be accurately measured as it progresses and undoubtedly it was for that reason that the statute authorized 'reasonable' allowances * * * in order equably to spread that element of operating expenses through the years." *Gambrinus Brewery Co.* v. *Anderson*, 282 U. S. 638, 645. Therefore, all that is required is "A reasonable approximation of the amount that fairly may be included in the accounts of any year * * *." *Burnet* v. *Niagara Brewing Co.*, 282 U. S. 648, 655. See also *Koelling* v. *United States* (Neb.) decided February 14, 1957 (1957 P-H, par. 72,529); *Cohn* v. *United States* (W.D. Tenn.), decided February 25, 1957 (1957 P-H, par. 72,573), on appeal, C.A. 6th; *Terminal Realty Corp.* v. *Commissioner*, 32 B. T. A. 623, 629; *Davidson* v. *Commissioner*, decided September 24, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,317); *Bolta Co.* v. *Commissioner*, decided November 28, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,360, modified, par. 45,372).

We fully recognize the fact that useful life for depreciation purposes is an estimate. Nor do we dispute the proposition that salvage value is an estimated figure which must be determined initially at the date of acquisition of the property, when the amount of allowable depreciation is first established. We do contend, however, that Section 23(l) requires a reasonable approximation of depreciation on the basis of the actual experience and practices of the business involved. We also dispute any contention that, once estimates of useful life and salvage value have been initially made, the parties are precluded from thereafter adjusting the estimate where it is obviously in error.[25] As noted, the reasonableness of any claim for depreciation is determined upon the conditions known to exist at the end of the period for which the return is made and, when it is obvious that a fact involving useful life or salvage value is in error, the deduction is to be corrected in that year and in any subsequent year. *Washburn Wire Co.* v. *Commissioner*, 67 F. 2d 658 (C. A. 1st); *Commissioner* v. *Mutual Fertilizer Co.*, 159 F. 2d 470 (C. A.

[25] See Rev. Rul. 90, 1953-1 Cum. Bull. 43; Rev. Rul. 91, 1953-1 Cum. Bull. 44.

5th); *Leonard Refineries, Inc.* v. *Commissioner*, 11 T. C. 1000, 1006-1007; *Weir Long Leaf Lumber Co.* v. *Commissioner*, 9 T. C. 990, 998, reversed on other grounds, 173 F. 2d 549 (C. A. 5th); Treasury Regulations 111, Section 29.23(l)-5.

Contrary to taxpayer's assertions (Br. 26, 42), the evidence clearly shows that well prior to the taxable years 1950 and 1951 taxpayer had reason to know that he was not going to be using his cars for anywhere near their full physical life, which he alleges to be four years. Likewise, it is clear that taxpayer reasonably knew, well prior to the years 1950 and 1951, that he would recover a substantial portion of the cost of the cars when he sold them. Certainly, his computation of a zero salvage value was clearly erroneous and demanded adjustment. The taxpayer has testified (R. 79-81) and the Tax Court has found (R. 28, 31) that, at least since 1949, the customers of U-Drive demanded "automobiles that were currently in style." Time was more important than mileage in taxpayer's business (R. 81), since many of taxpayer's cars were used in the tourist business and were sold off at the end of the tourist season, i.e., Labor Day (R. 27-28, 46). Taxpayer himself testified that during the years in question he was holding the extended-term lease cars between eighteen to thirty-six months and the short-term rental cars between fourteen to sixteen months. (R. 45, 54, 63-64, 79-81.) An examination of the schedules attached to taxpayer's returns for the years 1947 to 1951 (See Exs. 5, 11, A, B and C) shows that, except during World War II and immediately thereafter, taxpayer was using the cars for a short period of time, and that during the taxable years in question he could have reasonably estimated the length of time he would use the cars in the two types of rentals.[26]

Likewise, the record clearly shows that when taxpayer acquired the automobiles he could have made a reasonably close estimate of the resale value of the cars, particularly the 60 to 70 per cent which he held on an average of fifteen months. The taxpayer has testified (R. 46-49), and the Tax Court has found (R. 28), that taxpayer had an established market with used car dealers, jobbers, or brokers for the sale of his cars. As Mr. Verhey, a used-car dealer, has testified (R. 57-62), the used car market is a highly organized and well-informed market. Every thirty days the National Automobile Dealers Association book was, and is, issued showing the prices being paid wholesale and retail for used cars of different ages, makes, and models. (R. 60). Taxpayer has been a proprietor in the rental-car business since 1936, and had worked for others in that business since 1924. (R. 26, 42.) It is obvious from his long experience in buying, renting and then selling cars that taxpayer was well aware of the methods employed in the used car market and the information available therein. With his years of experience and the market information available to him, it is inconceivable that taxpayer, having a good idea of how long he would use his cars and who would probably

[26] The capital gains schedules attached to taxpayer's returns for the years 1952 through 1954 (Exs. D, E, and F) indicate that taxpayer's established business practice of only holding cars for a short time is fixed and continuing.

buy them, could not have made a reasonable estimate when he bought a car of the resale value that would be recovered when he sold it.

Taxpayer has testified that he could not estimate how long he would hold a car or what its sales price would be when he sold it because of the possibility of strikes, technical advances in building automobiles, and war. (R. 66-67, 69, 70-71.) The short answer is that all taxpayer is required to do is make a "reasonable" estimate. The rates and estimates involved in a depreciation computation are subject to adjustment if some unforeseen development would make them unreasonable for the taxpayer's business, particularly in the case of war. Taxpayer's excuses are especially unconvincing in the light of the fact that he has completely ignored the realities of his business, and the Tax Court was clearly correct in rejecting his testimony. Strikes in the auto industry might, of course, delay delivery of new cars for a month or so and drive up temporarily the value of used cars. Such contingencies, however, are fairly minor over a fifteen-month or a three-year period, and are subject to reasonable estimation and adjustment. It is also common knowledge that there was and is considerable advance notice about technological developments in automobiles. Important mechanical developments are introduced over a period of several years. Clearly, in this case obsolescence due to mechanical developments did not present an insurmountable barrier to a reasonable estimation of the useful life and salvage value of taxpayer's automobiles. In respect to estimating salvage value, the instant case is similar to

Koelling v. *United States*, *supra*, where the District Court noted that in intelligently estimating salvage value the cattle breeder had the benefit of the sales price information provided by the Omaha livestock market. Indeed, as the Tax Court expressly noted (R. 31), the findings here are based upon the conditions known to exist at the end of the two years for which the returns were made, and not upon conditions which developed years later. Treasury Regulations 111, Section 29.23(l)-5. (R. 28-30; Exs. B and C.)

The taxpayer also argues (Br. 29-30, 43-44) that the Tax Court's findings regarding salvage value are based upon a so-called invalid "sales proceeds theory." It is true that the Regulations state that salvage value may not be changed merely because of a change in price levels. Thus, minor fluctuations in market value, which affect the estimated salvage value used in computing depreciation, will not be used to adjust the allowable depreciation for a particular year. However, where market value fluctuates a great deal so that the depreciation allowance is obviously distorted, the Commissioner has sought the adjustment thereof, and the courts have held that, in such circumstances, the salvage value should be adjusted. See *Horace Williams Co.* v. *Lambert* (E.D. La.), decided July 10, 1956 (1956 P-H, par. 72,920), affirmed without discussion of this point, 245 F. 2d 559 (C.A. 5th).[27]

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[27] In that case the salvage value of a particular asset, in 1948 and 1949, was $50,000. In 1950, the tax year in question, the salvage value fluctuated from zero to $30,000. The

Indeed, it is clear that the Commissioner did not base his determination nor did the Tax Court base its decision in this case solely on the sales prices of the cars. Other circumstances such as the short period that taxpayer was holding the cars clearly indicated that a reasonably estimable salvage value existed far in excess of the zero value which taxpayer claimed. It should also be noted that the Tax Court's findings in regard to salvage value are not limited to the results in a few sales but are based on almost three hundred sales in an open market over the two taxable years. (R. 28-30.) The amount ultimately received on sales, when known, is certainly of assistance to the court in determining what a reasonable estimate would have been. Actual experience can be used to justify an estimate of salvage value. *Bolta Co.* v. *Commissioner, supra.; Davidson* v. *Commissioner, supra.* Indeed, the actual sales price has been held to be the best indication of the estimated salvage value. See *Caruso* v. *Commissioner*, 23 T. C. 836, where the actual sales price was used to adjust salvage value (and allowable depreciation) adversely to the Commissioner. The realities and economics of the situation control the determination of the proper estimate of salvage value (*Koelling* v. *United States, supra*), and the court is concerned with adjusting depreciation to its "true picture" (*Humphrey* v. *Commissioner, supra*). Certainly, the court is not expected to close its eyes to what actually

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court found that an estimated value of $30,000 was fair and reasonable and the depreciation allowance for 1950 was adjusted accordingly.

occurred in marshalling the facts relevant to making its finding of what was a reasonably estimable salvage value.[28] We submit that the Tax Court's find-

[28] We believe that taxpayer's reliance (Br. 30, 44) on *Denny* v. *Commissioner,* 33 B. T. A. 738, is misplaced. As already indicated, the Tax Court's findings regarding depreciation are not based solely on "shrinkage of market value." The findings are based on the depreciation in the value of the cars due to obsolescence in taxpayer's business, and wear and tear.

Similar cases such as *Thos. Goggan & Bro.* v. *Commissioner,* 45 B. T. A. 218; *Weir Long Leaf Lumber Co.* v. *Commissioner, supra*; and *Transoceanic Terminal Corp.* v. *Commissioner,* decided March 18, 1954 (1954 P-H. T. C. Memorandum Decisions, par. 54,080), are also distinguishable. Each case turns on its own facts. Thus, in *Thos. Goggan & Bro.*, the Board merely held (pp. 224-225) that the difference in the trade-in value of an automobile (which was $206.89 less than the depreciated, or book, value thereof) would not, *by itself* and without evidence of actual usage, be sufficient evidence to support the contention that the actual depreciation was in excess of that already claimed. In *Weir Long Leaf Lumber Co.*, the court's holding with respect to the mill property (9 T. C., pp. 998-999) fully supports the Tax Court in this case (*i.e.*, that estimated salvage value, as well as estimated useful life, is to be determined upon conditions known to exist at the end of the tax year and, when it is apparent that the factor of salvage value is erroneous, an adjustment of the error should be made.) In regard to the automobiles involved, the court expressly noted (9 T. C., p. 999) that the issue was narrowed, by stipulation, to whether the price received upon the sale of the asset, by itself, precluded any depreciation allowance for the year in question. The court, citing *Goggan,* held that it did not. *Transoceanic Terminal Corp.* merely held that, on the facts of that case, the average trade-in value of an asset, by itself, was not sufficiently accurate evidence of the reasonably estimable salvage value, because unusually high allowances were granted to induce the taxpayer to purchase new equipment. The distinction between ings and opinion are fully supported by the facts and the law.

E. *The opinion of the Tax Court is in full accord with the purpose of Section 117(j) of the Code.*

Finally, taxpayer argues (Br. 31-36) that the Commissioner, and apparently the Tax Court, are trying to obviate Section 117(j) of the 1939 Code (26 U. S. C. 1952 ed., Sec. 117(j)). That section permits capital gain upon the sale or exchange of certain property used in trade or business. What taxpayer overlooks is the fact that Section 117(j) must be interpreted and applied in conjunction with Section 23(l)'s direction that only a "reasonable allowance" for depreciation be deducted. This is true due to the fact that the basis which is used to determine capital gain under Section 117(j) is the original cost of the asset less the depreciation deducted therefrom, *i.e.*, depreciated cost basis. (See Exs. B and C.) In recently dealing with the purpose of Section 117, the Supreme Court stated in *Commissioner* v. *Lake*, 356 U. S. 260, 265, that:

> The purpose of § 117 was "to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of

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the former cases and this case are clear. In this case, there are factors in addition to the actual sales price of the assets upon which the reasonableness of the estimates are based. Here, the evidence showed substantial discrepancies between estimated and actual useful life and estimated and actual salvage value. The actual salvage value of the cars was simply another factor considered in determining a reasonable depreciation allowance.

> those burdens on such conversions." See *Burnet* v. *Hormel*, 287 U. S. 103, 106. And this exception has always been narrowly construed so as to protect the revenue against artful devices. See *Corn Products Refining Co.* v. *Commissioner*, 350 U. S. 46, 52.

The effect which the Tax Court's opinion has upon taxpayer's capital gain income stems solely from the fact that the court has followed Congress' direction to permit annually, as an expense of a business, the deduction of only a reasonable depreciation allowance. Furthermore, contrary to taxpayer's claim (Br. 31, 35), the decision of the Tax Court does not deny him capital gain upon the sale of his cars. For example, taking the average cost and sales price for 1950 and 1951, as found by the Tax Court (R. 28-29), and the holding of the court regarding the depreciation computation for short-term rental cars for the years 1950 and 1951 after fifteen months' use of a car (*i.e.*, the useful life of a short-term rental car in taxpayer's business), the taxpayer would average approximately \$5 capital gain per car in 1950 and approximately \$20 capital gain per car in 1951. This, of course, is considerably less than taxpayer claimed during those years after taking an excessive depreciation allowance. There is nothing in Section 117(j), however, which guarantees capital gain to a taxpayer. The Tax Court's opinion merely results in the capital gain being predicated upon a reasonably depreciated cost basis. This is clearly in accord with the Congressional purpose.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APPENDIX A

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be allowed as deductions:

*   *   *   *

(l) [as amended by Sec. 121(c) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

*   *   *   *

(26 U. S. C. 1952 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23(l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. Due regard must also be given to expenditures for current upkeep. * * *

SEC. 29.23(l)-2. *Depreciable Property.*—The necessity for a depreciation allowance arises from the fact that certain property used in the business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. It does not apply to bodies or minerals which through the process of removal suffer depletion, other provisions for this being made in the Internal Revenue Code. (See sections 23(m) and 114.) Property kept in repair may, nevertheless, be the subject of a depreciation allowance. (See section 29.23(a)-4.) The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income. No such allowance may be made in respect of automobiles or other vehicles used solely for pleasure, a building used by the taxpayer solely as his residence, or in respect of furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.

SEC. 29.23(l)-4. *Capital Sum Recoverable Through Depreciation Allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113(a) and 114.) To this amount should be added from time to time the cost of improvements, additions, and betterments, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. (See section 113(b).) * * *

SEC. 29.23(l)-5). *Method of Computing Depreciation Allowance.*—The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If the cost or other basis of the property has been recovered through depreciation or other allowances no further deduction for depreciation shall be allowed. The deduction for depreciation in respect of any depreciable property for any taxable year shall be limited to such ratable amount as may reasonably be considered necessary to recover during the remaining useful life of the property the unrecovered cost or other basis. The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, taxpayers must furnish full and complete information with respect to the cost or other basis of the assets in respect of which depreciation is claimed, their age, condition, and remaining useful life, the portion of their cost or other basis which has been recovered through depreciation allowances for prior taxable years, and such other information as the Commissioner may require in substantiation of the deduction claimed.

A taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation allowance or of his action in taking an allowance plainly inadequate under the known facts in prior years. * * *

APPENDIX B

Treasury Regulations on Depreciation (1954 Code):

Sec. 1.167(a)-1. Depreciation in general—

(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probably future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and Section 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation, or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, Section 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see Sections 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

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